C.D. Howe Institute
Commentary

The Border Papers

Mexico

NAFTA and the Prospects for North American Integration

Rogelio Ramirez De la O

In this issue...

In the past decade, Mexico has made great progress in its campaign to deregulate and privatize its industries as it works to deepen North American integration. The energy industry is proving to be the most politically difficult one to remove from state control. If it can be deregulated, however, energy promises to open up large investment inflows from Canadian and US investors.

The Study in Brief

The North American Free Trade Agreement (NAFTA) has had a profound effect on Mexico's trade and foreign direct investment. In 2000, to keep the process going, Vicente Fox, the new Mexican president, introduced proposals for deepening North American integration — including a common currency, a system of fiscal transfers for development in Mexico, and the free movement of labour among the three NAFTA partners. But September 11 put this grand vision on hold. Mexico must now focus on domestic reforms and a more selective regional integration agenda before pressing forward at the North American level.

Key Mexican industries — such as energy, financial institutions, and telecommunications — need restructuring, as does the labour market. The diverse nature of these reforms and the complex political arrangements they require suggest that change in Mexico and, therefore, its greater integration with the rest of North America, will be gradual and incremental, not sudden or dramatic.

One ambitious area for increased Mexican integration is in the energy sector, but complete deregulation of that state-controlled sector would require changes to Mexico's constitution. Other sectors that could help deepen North American integration are infrastructure, airlines, and financial services. Monetary integration is politically feasible, but not economically feasible, necessary, or desirable.

Little progress is, however, likely over the next year or so. Political conditions may improve sufficiently after the 2003 Mexican congressional election to allow negotiations on constitutional changes that would permit foreign investment in electricity and gas. Constitutional changes are also needed to modernize Mexico's labour laws, but such reforms may be delayed by political stalemate arising from the next presidential elections in 2006. Moreover, difficult relations between the president and the congress may mean that the reform process, on which much of the North American agenda ultimately depends, will probably extend through about 2009.

The Author of This Issue

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The Border Papers

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Mexico is at a crossroad. Its government is trying to implement a new phase of domestic structural reform, deepen the country's economic integration with the rest of North America, and manage a political transition to a modern democracy. Any one of these objectives alone could consume the full time and resources of an administration. Complicating the agenda is Mexico's inclusion of ambitious plans to engage the United States and Canada in new cooperative agreements that would go beyond free trade and may never prove feasible. And, since September 11, 2001, any new agreement within North America has become more difficult because the United States, the primary focus of President Vicente Fox's strategy, has shifted its attention away from regional issues to confront global challenges as its top priority.

Fox's boldest proposals on integration, publicized soon after the July 2000 presidential election, were to create a North American currency, a system of fiscal transfers for development in Mexico, and the free movement of labour within the region. Fox based his vision (and his actions during the first year and a half of his administration) on the belief that international agreements, such as the North American Free Trade Agreement (NAFTA), will boost business confidence and investment in Mexico, helping to accelerate growth and create jobs. In developing this vision, however, Fox seems to have ignored the fact that, before Mexico joined the NAFTA, it had made substantial progress on trade and investment liberalization. In trying to drive the NAFTA to greater depths, Mexico should, therefore, first undertake badly needed domestic reforms, for which new international agreements can be no substitute.

The main structural reforms Mexico now needs to undertake in order to complete the transition from a highly regulated economy to a market economy include the restructuring of both the labour market and key industries, such as financial institutions, energy, and telecommunications. The diverse nature of these reforms and the complex political arrangements they require suggest that change in Mexico and, therefore, its greater integration with the rest of North America will be gradual and incremental, not sudden or dramatic.

Domestic structural reforms would improve conditions for greater North American integration because they would create new opportunities for business, which typically benefits from international integration and synergies across national borders. Foreign investment would be attracted into newly deregulated areas of the economy; without such inflows, new international agreements cannot do much to increase integration. For that reason, it is more likely that Canada and the United States will see the advantage of new treaties with Mexico once reforms materialize and conditions improve for new business opportunities.

During the past decade, Mexico has made great progress deregulating and privatizing industries, but the work is still incomplete in several areas, especially the energy sector. Reforming that sector would unlock opportunities for large investment inflows from Canadian and US investors. Energy is, however, traditionally a political matter in Mexico, so negotiations to deregulate it will be intense and time-consuming. In the next year or so, little progress is likely. Once the 2003 congressional election is out of the way, political conditions may improve sufficiently to allow for negotiations that lead to constitutional change and permit foreign investment in electricity and gas.

After 2004, other reforms are possible, but, because of difficult relations between Mexico's president and its congress, the reform process, on which much of the North American agenda ultimately depends, will probably extend through the middle of the following presidential administration — that is, until about 2009.

The Implications for Canada

Mexico's international relations are overwhelmingly focused on the United States. One result is that the Mexican government and business often limit their view of the potential of the NAFTA to that of the US-Mexican relationship. Nonetheless, certain firms and parts of the government view Canada as an influential player in North American integration, one that has significant capital and technological expertise in energy, both of which Mexico needs desperately. Furthermore, the Mexican government sees Canada as a potential supporter of some of its proposals for a wider and deeper NAFTA. And if the United States develops a unilateral stance on trade, as its current steel tariffs and agriculture subsidies suggest, Mexico and Canada may find common interest in specific bilateral agreements (in which the United States might later join). Indeed, the two countries could use each other as allies in trying to achieve more secure access to many US markets.

Mexico's structural changes started not with the NAFTA but with trade liberalization in the 1980s followed by privatizations in the early 1990s.

Also, Canada should remember that, although its and Mexico's issues differ, the United States finds it politically difficult to develop integrative initiatives without parallel US-Mexican initiatives. The demands of political symmetry are insistent. So Canada faces an extra hurdle in trying to convince the United States to pursue any kind of bilateral framework. Thus, any such vision must be developed with a clear way of bringing in Mexico, at least eventually.

The Outline of the *Commentary*

The *Commentary* proceeds as follows. I begin by looking at Mexico's current situation: a macroeconomic review and some of the specific effects of the NAFTA and other recent impacts on trade. Next, I recount some of the country's recent history and detail President Fox's proposed reforms. Then I turn to the future of integration in various areas. A brief conclusion closes the study.

The Sources of Mexico's Strength

Mexico's structural changes started not with the NAFTA but with trade liberalization in the 1980s followed by privatizations in the early 1990s. Once the NAFTA was signed, these changes became firm, attracting new investments, improving efficiency, and raising productivity across the economy. Table 1 shows the economy's performance during successive periods, from the administration of President Miguel de la Madrid, who initiated the opening of the economy (1983–88); followed by President Carlos Salinas (1989–94), the crisis of 1995, and the successful stabilization and growth led by President Ernesto Zedillo (1996–2001).

Macroeconomic Overview

The dramatic change in the performance of the Mexican economy before and after the implementation of the NAFTA is evident in the table. Although the country

Table 1: ***Mexico's Economic Performance by Presidential Period, 1983–2001***

	1983–88	1989–94	1995	1996–2000	2001
GDP *(annual growth %)*	1.1	3.9	-6.2	5.5	-0.3
Manufactured exports *($ billions, annual average)*	7.3	33.3	66.6	109.7	143.1
Current account balance *(% of GDP)*	1.1	-3.2	-0.6	-2.6	-2.8
Foreign direct investment) *($ billions, annual average)*	2.3	4.6	9.5	11.8	24.7
Foreign debt, end of period *(% of GDP)*	58.9	36.6	61.8	30.3	27.9

Note: All money amounts are in current US dollars.

Sources: Ecanal; Instituto Nacional de Estadística Geografía e Informática.

suffered a devaluation and financial crisis in 1995, only a year after the NAFTA went into effect, trade continued to expand, allowing for a quicker recovery from the crisis than would have been possible without high export growth. In 1994, the current account deficit on the balance of payments reached 6.8 percent of gross domestic product (GDP), or $29.7 billion,[1] owing to a heavily overvalued peso, fell in 1995 to 0.6 percent of GDP, then stabilized in subsequent years at a low level.

Thus, for the first time in more than 30 years, Mexico saw a reduction in its external current account deficit, even with import growth as high as 19.3 percent annually during the 1996–2000 period. The current account deficit averaged only $11.6 billion and never exceeded $18 billion even in 2001, when the United States went into recession and Mexico's exports fell by five percent. One of the advantages of the NAFTA was that it allowed Mexico to grow at higher rates than before 1995 without suffering balance-of-payments crises, as had been its experience from the 1970s through 1994.

Of considerable importance in this turnaround have been privatization in some sectors and a large increase in foreign direct investment (FDI). And, after the NAFTA was put in place, employment in manufacturing, which had not risen for 15 years, grew 2.5 percent per year, interrupted only in 2001 by the effects of the US recession (Instituto Nacional de Estadística Geografía e Informática [INEGI]).

Privatization

Privatization has represented an important positive change for Mexico's macroeconomy. At the beginning of the 1990s, Mexico had a bloated and inefficient state-owned sector exceedingly diversified among steel, fertilizers, hotels, banks, insurance, telephones, and many stakes in the manufacturing industry. Privatization was a sound policy because it reduced the size of the state and budgetary transfers. But a major flaw of the privatization program implemented between 1989 and 1993 was that it involved sales of entities to investors with whom the president had a close relationship. In most cases, the true terms of the sales were not made public or transparent; worse, many of the investors acquiring the companies were unsuccessful in operating them, relying on government favour and protection via regulations.

These deficiencies explain why many of the largest privatized entities went bankrupt by 1995, after the peso devaluation. As the new government of President Zedillo faced a crisis for which it had to obtain extraordinary loans from the US treasury and raise taxes to keep the fiscal deficit from rising, the whole idea of privatization became discredited in the markets and among political groups.

1 Unless otherwise noted, all money amounts herein are expressed in current US dollars.

The Fox administration wants to carry out new privatization projects in electricity, gas, and toll roads. But with the bad experience of the 1990s in the background, Fox must first convince a skeptical congress and public opinion that his privatizations will not repeat the old vices.

Foreign Direct Investment

Foreign direct investment in Mexico nearly tripled from $4.6 billion annually before the NAFTA to $11.8 billion after it (see Table 1). The $24.7 billion peak in 2001 was particularly high owing to Citibank's $12.5 billion acquisition of Banamex, the country's second largest bank. Even so, the current inflow of FDI, about $14 billion per year, is large and is likely to increase to $25 billion per year if the energy sector is liberalized.

This sharp rise in FDI is not entirely the result of the NAFTA — they had begun a few years earlier when Mexico started easing restrictions on foreign investment — but the agreement made such changes credible. In oil and the railways, those restrictions went back to the 1930s. In the 1960s, new laws extended constraints on FDI to radio and television, road transport, forestry, and gas distribution. Other restrictions limited foreign participation to between 34 and 49 percent in agriculture, rubber, publishing, soft drinks, commercial films, urban transport, maritime and air transport, mining, cement, steel, glass, fertilizer, cellulose, aluminium, arms and explosives, and banking. In other activities, a 1973 law held FDI to 49 percent.

Foreign direct investment in Mexico nearly tripled from $4.6 billion annually before the NAFTA to $11.8 billion after it.

This restrictive regime lasted until 1989, when a gradual relaxation began that culminated in 2000 in the opening of Mexican banks to full foreign ownership. Only a few restrictions continue to apply, most significantly in oil and electricity, although the latter have been relaxed through various regulations during the past eight years (Ortega 2002).

The NAFTA guarantees national treatment to any investor from a partner country, creating a propitious climate for relaxing restrictions. The consensus in Mexico is that FDI has transformed industry into operating more efficiently than it did under full domestic ownership, paying higher wages, and dedicating more resources to training workers. Moreover, FDI has led to gradual improvements in corporate governance, which Mexican regulators and business had ignored until recently. A 2001 law was the first to establish rules for the conduct of boards of directors and the protection of minority rights in public firms (Mexico 2001).

After the NAFTA came into force, Canadian FDI in Mexico rose at a rapid pace from negligible amounts. Canada now seems likely to increase its stake in Mexico manyfold if and when sectors such as electricity, natural gas, and crude oil are liberalized. In many cases, Canadian firms would find in Mexico a natural field for geographical expansion and for linking production facilities in the three North American countries.

Labour Markets

The NAFTA has led to an increase in employment in Mexican industry and services, offsetting job losses in farming. In sectors where employment has risen, output has jumped, so that productivity is much higher than it was before the NAFTA. This

advance is reflected in the steady increase in real wages from as low as a tenth of US wages in the 1980s to a sixth now. Very gradually, wages in Mexico are catching up with the higher wages in Canada and the United States (INEGI).

Labour productivity in Mexico's manufacturing industry, measured as the ratio of output to employment, grew 38 percent during the 1980s, or about 3.3 percent per year. From 1990 through 2001, growth accelerated to 5.8 percent per year (Ramirez 2000; Alberro 1997), undoubtedly the result of greater investment and improved efficiency under competitive pressures. The NAFTA was a major catalyst of growth in productivity, for it appears to be highly correlated with exports (Ramirez 1998b, 10).

Even so, labour needs further deregulation, as current law grants excessive protection to unions and workers. In that sense, Mexico's employers have much less flexibility than their counterparts elsewhere in North America. In 2001, the combination of recession in the United States and a strong peso exchange rate led some multinational manufacturers, citing high labour costs, to close down operations for the first time in many years (Luhnow 2002). Indeed, these closures contributed to a 3.9 percent fall in manufacturing employment last year.

While wages rise at high rates and labour markets continue to be overregulated, it seems unlikely that Mexico can continue to attract FDI in manufacturing and remain globally competitive. In the absence of labour reform, wages must stop rising or manufacturing employment and output will grow at much lower rates than we have seen in recent years.

The NAFTA has been the vehicle for a surge in Mexico's international trade.

The NAFTA's Sectoral and Regional Impact

The NAFTA has been the vehicle for a surge in Mexico's international trade (see Table 2). Between 1990 and 2000, exports increased dramatically from $41.0 billion to $166.4 billion. Imports recorded a similarly high increase, accentuating the link between the growth of exports and imports.

Sectoral Effects

The surge in trade has brought Mexico many benefits, although they are not spread evenly across the country's economic sectors.

The Auto Sector. Mexico's auto sector has been a clear winner from the NAFTA (Doh 1998, 523), its exports jumping almost four percentage points of GDP between 1990 and 2000. That increase had started before the NAFTA was in place, but the agreement provided greater certainty for investors. By maintaining a rule-of-origin of 62.5 percent of North American cost content for cars, light trucks, engines, and transmissions and a 60 percent minimum for other vehicles, the NAFTA encouraged producers to enhance their core operations for assembly and engine production in Mexico.[2] Auto production in Mexico jumped from 1.055

2 It also discouraged the operation of plants that have no core production in North America, especially by Asian producers, with the exception of Nissan, which had a large operation, and, later on Honda, which has developed production.

Table 2: ***Mexican Exports and Imports, Total and Selected Manufactures, 1990 and 2000***

	1990	2000
	(% of GDP)	
Exports	15.9	29.0
Manufactures	11.2	25.5
Transport equipment	5.0	8.9
Electrical and electronic goods	2.7	8.6
Imports	16.1	30.4
Manufactures	10.9	28.8
Transport equipment	5.3	7.8
Electrical and electronic goods	2.8	7.8

Source: Bank of Mexico, "Indicadores del Sector Externo," various years.

million cars and trucks in 1993 to 1.854 million in 2001. Exports increased threefold to 1.382 million, and domestic sales nearly doubled to 918,835 (AMIA 2001, 28). Employment in the industry has increased by 4.1 percent annually and employment in auto parts by 4.8 percent annually since the NAFTA was implemented. The NAFTA has also facilitated specialization in production and an ever-diversifying domestic market with fast growth in imports, as has been the experience in other countries (Barker 1977; Schott 2000; Funke and Ruhwedel 2001).

As Mexico underwent a change in its product mix and exports expanded rapidly, auto firms made new investments to upgrade quality. By 1998, no difference remained between the quality of cars built for export and that of cars made for the domestic market. In this sense, the industry has placed itself above the standards of auto industries in South America (Ramirez 1998). And growth in domestic demand has attracted new entrants (Mercedes Benz and Honda), while Peugeot has started to sell on the basis of a free trade agreement with Chile.

Mexico is now the world's eighth-largest producer of cars and fifth-largest maker of trucks. The industry has in place all the regulations necessary for increased trade and investment, as well as a growing domestic market. Good performance and productivity growth make the Mexican auto industry a key for future integration within North America, but it requires continued simplification of taxes, customs, and labour regulations, where it is less competitive than its Canadian counterpart.

Electronics. Exports of Mexican electrical and electronic goods — primarily electrical household appliances, telecommunications equipment, computers, photocopiers and printers, electrical circuits and controls, and cellular telephones — jumped from $7.0 billion (2.7 percent of GDP) in 1990 to $49.2 billion (8.6 percent of GDP) in 2001 (see Table 2). Imports rose similarly. Most of the firms in this industry operating in Mexico are of US origin, but leading Japanese and European firms are also significantly represented.

Textiles. Trade in Mexico's textile industry, which originally contained a large segment of maquiladoras (mainly foreign-owned plants allowed to import all materials duty free provided they are re-exported)[3] has grown impressively. Evidence that this industry has been a winner from the NAFTA is reflected in the growth of exports from 0.5 percent of GDP in 1990 to 2.2 percent in 2000, and of

3 For a discussion of the current situation of the maquiladoras, see below.

imports from 0.7 percent to 1.7 percent. This trade-based growth has contributed to significant improvement in quality and to lower clothing prices for consumers, as producers have become more competitive through the use of imported materials.

Traditional Manufactures. Mexico's traditional manufacturing sector includes food and beverages, steel, and nonmetallic minerals. The growth in exports of food and beverages is explained by expansion in capacity, facilitated by greater certainty that Mexican products — including beer, tequila, and fruit juices — now enjoy unrestricted access to North America. Firms have also developed extensive advertising in the NAFTA market, strengthening successful brands.

Trade in steel and nonmetallic minerals has been less dynamic, owing to problems of worldwide excess capacity in these industries. In addition, producers of cement, under continued restrictions, have concentrated their sales efforts in Mexico, rather than on exports. The largest producer, Cemex, has followed a strategy of international expansion by acquiring foreign producers on a global scale. All the same, an important investment incentive for this and other large producers of industrial commodities was the improvement in the business climate, to which the NAFTA has contributed greatly.

The NAFTA has presented a difficult challenge for Mexican agriculture.

Agriculture. The NAFTA has presented a difficult challenge for Mexican agriculture, where many small, traditional farmers combine growing corn with other farm products in a tradition that goes back centuries. In contrast to general expectations at the time the agreement was negotiated, the displacement of domestic produce by cheaper imports has not resulted in farmers' finding occupation in other activities (Jacobs 2001). One result has been that many poor peasants have abandoned their land and migrated to the north. Other small farmers continue to produce for family consumption, but under conditions of extreme poverty.

Sugar is another industry unable to sell all of its production in Mexico or abroad. The manifestation of this problem has been the bankruptcy of many sugar mills and the government's financial rescue of 27 of them in 2001, after years of continued losses. Bad trade performance in agriculture has doubtless had profound social and political implications in Mexico, which explains why the Fox government had to rescue sugar mills. One result is that the federal budget has become burdened with high growth in subsidies.

Mexico tried to impose extraordinary duties on imports of corn-fructose syrup, in an attempt to protect the domestic sugar industry's sales to soft drink producers. More recently, in 2002, congress approved a 20 percent tax on the sale of soft drinks produced with such syrup, but the executive, fearing a conflict with the United States, issued a decree that reversed this tax. Later, however, the supreme court ruled that the executive has no authority to legislate taxes. For the sugar industry, which involves 300,000 sugar cane producers, the problem remains unresolved.

Difficulties in farming do not go far enough to question the overall benefits of the NAFTA, but sooner or later these problems will force the Mexican government to grant protection to some producers or to try to discuss specific trade problems with its North American partners (although this approach seems difficult now).

Services. The NAFTA and increased FDI have boosted services. Transport and communications, which had grown five percent annually between 1990 and 1993, before the NAFTA, jumped by nine percent annually from 1995 through 2000. Growth is likely to accelerate as transport between Mexico and the United States has been freed from most previous restrictions. Telecommunications have been opened to new entrants, even though the NAFTA kept basic telecommunications under the control of Mexicans. Foreign investors have been active, however, in other telecommunications services.[4]

Tourism is another area of services in which foreign investment has grown significantly since the NAFTA was implemented, particularly in developments in Baja California and Cancún.

In banking, foreign investors dominate today, even though the NAFTA permits Mexico to limit FDI in this sector. The largest Mexican bank (Bancomer) is now under the control of BBVA of Spain, while the second largest (Banamex) was entirely absorbed by Citigroup. New investors have also purchased smaller banks, with foreigners participating prominently.

Banking has proved an attractive field for Canadian investors since Scotiabank established a solid core by acquiring a bank with high market penetration, including brokerage and other financial services. Canadians are competing in Mexican banking against US (Citigroup) and Spanish (BBVA and Santander) investors in a market that has good potential for growth, with bank credit to the private sector being only nine percent of GDP at present.

Export and manufacturing activity have been concentrated in the northern region, especially along the US border.

Regional Effects

For the past five years, the leading forces of growth in Mexico have been exports and investment, both closely linked to the NAFTA, which has caused uneven growth across regions. The reason is that export and manufacturing activity have been concentrated in the northern region, especially along the US border. Also seeing high growth have been the industrial area north of Mexico City, as well as Guadalajara, Monterrey, and Aguascalientes. But the south of Mexico has lacked FDI and exports. Such a regional imbalance has been aggravated by the budgetary constraints of the federal and state governments, preventing them from investing in infrastructure and social services. The inevitable result has been larger-scale migration from the southern states northward and eventually illegally into the United States.

At the same time, high growth in the north has put great pressure on public infrastructure and social services, leading in some instances to extremely poor environmental conditions, a lack of water, and shortfalls in other public services. The Fox government has announced an ambitious plan (Plan Puebla-Panama) to increase investment in infrastructure and to connect Mexico with Central America through more roads, telecommunications, and seaports. But lack of sufficient finance means that this plan is still far from materializing.

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4 In long-distance services, the leaders have been MCI and AT&T. In cellular telephones, Vodafone, Verizon, Sprint, and Telefónica Española are now participating. Mexican Internet services are provided by Microsoft, AT &T, AOL, Yahoo, and Telefónica de España.

The Maquiladoras[5]

The maquiladoras, most of which are on the northern border, were created in the mid-1960s to give foreign firms an incentive to locate operations in Mexico and take advantage of its cheap labour. At first, these plants were not large, employing only 200,000 workers as late as 1983. Since that year, and particularly since the implementation of the NAFTA , employment by the maquiladoras has increased dramatically, to 600,000 in 1994 and to 1.2 million in 2000.

Initially, the maquiladora plants assembled electronics and clothing. In recent years, however, they have begun to assemble more complex products, including electrical control equipment, electronics, and auto and aircraft parts. Although the coming of free trade obviated their duty-free advantage over other industries, they have nevertheless continued to expand. As their output is directed mainly to the United States and Canada, they continue to be linked to North American integration, which explains their high growth since the NAFTA was implemented (Gruben 2002).

Maquiladoras now account for 45 percent of Mexico's exports. Through 2000, their growth owed much to low wages. Since then, however, wages in Asia have fallen (because of currency devaluation) but they have continued to rise in Mexico. With the strengthening of the peso between 1999 and 2001, wages paid by the maquiladoras jumped by 30 percent in dollar terms, forcing some plants to move to Central America or Asia.

Between 1995 and 2000, Mexico signed nine free trade agreements with Latin American countries, Europe, and Israel.

In 2001, more than 500 maquiladoras employing 300,000 workers closed in response to the combination of the strong peso, high wages, and the US economic slowdown. A continuation of these factors would probably cut the size of the maquiladoras still further, at least in sectors sensitive to wage rates. The future of the maquiladoras and of employment in northern Mexico depends on whether the peso stops appreciating and labour unions become more flexible in negotiating wages.

Other Influences on Trade

Mexico's NAFTA partners are not the only countries with which it has special trading arrangements. Between 1995 and 2000, Mexico signed nine free trade agreements with Latin American countries, Europe, and Israel. It is also a member of the World Trade Organization (WTO).

Non-NAFTA Trade Agreements

Mexico pursued non-NAFTA trade agreements not as an alternative to its North American strategy but more as a complement to it in an attempt to assure access for its exports to most markets. The thinking was that this would make investing in Mexico more attractive to international investors. Signing other agreements was also meant to give a political signal that the country was trying to diversify its trade relations and to appease nationalistic sentiment against high dependence on the United States.

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5 Maquiladoras are plants created under a special regime allowing them to import any amount of components provided they re-export all of them as part of a new product.

None of these other agreements has, however, yet resulted in significant amounts of trade (Anierm 2001; Jaramillo 2002). Although Mexico's exports to the European Union (EU) exceeded $5.6 billion in 2000, its trade with other countries remains insignificant, especially in the light of its trade with the United States. In practice, the web of trade agreements has not proven a powerful competitive advantage to attract FDI — at least foreign companies seldom mention it as a compelling factor in their decision to invest.

China and the WTO

Mexico was reluctant to agree to free trade with China, given the presence in Mexican markets of numerous Chinese products at prices so low that the government imposed antidumping duties on toys, plastics, clothing, and steel. Now that China has joined the WTO, the threat to Mexico has become even more serious since modern Chinese manufacturing and its large scale of production render uncompetitive many Mexican industries in sectors such as textiles, steel, clothing, and footwear. Because of this disadvantage, Mexico obtained from the WTO a seven-year grace period in which to phase out its high tariffs on Chinese goods. This reprieve will, however, allow Mexico only to adapt to, not eliminate, Chinese competition (Dussel Peters 2002). Consequently, traditional industries in some sectors may partially close or shift some manufacturing elsewhere, even to China.

No one can be certain about the speed at which Mexico's political institutions can adapt to the new system.

The Road Ahead

In thinking about Mexico's next moves, one needs to consider how it has come to its current state, the feasibility of President Fox's ideas and a reasonable schedule for implementing them, and the ways in which the events of September 11 have changed the realities of North America.

Some Recent History

In 2000, the Partido Acción Nacional (PAN), the right-wing opposition to the Partido Revolucionario Institucional (PRI), won Mexico's presidential election, ending a 70-year period of one-party rule and starting a political transition. This shift is toward a modern democracy, but no one can be certain about the speed at which Mexico's political institutions can adapt to the new system. One aspect of this transformation must be from an economy that remains highly regulated to one in which markets perform their essential role and investment is free to move across economic sectors.

Much of the PRI's decline originated in its inability to adapt and modernize the country's political institutions, especially after the NAFTA accelerated the forces of globalization, demanding lesser regulation and greater transparency in public affairs. Originally a left-of centre party, the PRI began market reforms in the late 1980s; by the early 1990s, it was applying the most orthodox economic policy in Latin America, in line with right-of-centre political values, as it discovered that doing so gained

Mexico foreign investment and higher economic growth. To accelerate market reforms, it made privatizations and pledged to keep fiscal deficits low.

But the task of liberalizing the economy in a consistent way was still far from complete when Mexico signed the NAFTA. The peso devaluation and the banking crisis of 1994–95 revealed the serious flaws of the PRI regime: the privatization of banks and many other firms had been tainted by corruption, splits among PRI factions had reached the top level of government, and crime and drug traffic were increasing. The PRI's early-1990s' deviations from free market rules caused popular resentment against new reforms, despite the pace of economic growth. In 2000, Mexico found itself committed to free trade and badly needing more market reforms to take better advantage of the NAFTA; key backward sectors, such as energy, still faced excessive regulation, and public opinion was turning against new privatization.

Vicente Fox, the PAN candidate, was elected on a broad platform of economic and political change that promised to break the deadlock and accelerate modernization based on genuine market reforms. In his campaign, Fox emphasized that Mexico could profit from North American integration, which was, in his view, the starting point for new international agreements. But the PAN did not win congress.[6] Thus, Fox's top priority must be to conduct meaningful political negotiations to turn his ambitious reform agenda into a feasible project.

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Some of the proposed reforms find great domestic support, partly because the NAFTA has created many new businesses and jobs that depend on free trade and could prosper more with greater liberalization. Some constituencies, particularly in northern Mexico, a region that has experienced unprecedented economic expansion since 1994, see new reforms as essential to cementing their position in the global economy and to attracting greater foreign investment. Changes are needed in energy, labour law, the regulation of small business, and the legal system, all of them necessary conditions for an improved business climate. But the fact that this consensus exists does not mean automatic congressional support for reforms. To gain that support, Fox must make thoughtful and detailed proposals on labour laws and private participation in energy, which is still controlled by the state. His submissions must convince all parties that he indeed has a new approach to reform based on strict market principles and without corruption. Such proposals would have to correct the failures of past reforms in a credible manner and be embraced with full conviction by a competent and well-coordinated cabinet. In the absence of this work, international agreements on deepening the NAFTA would lack political support in Mexico, even if they gained it from the Canadian and US governments.

In 2001, his first year in power, Fox started out on the wrong foot by proposing to tax food and medicine. He sought to rebalance the fiscal accounts, largely in order to accommodate the huge bailout of private commercial banks, which had cost $100 billion (20 percent of GDP). By not making explicit the cost of this aid and the rationale for taxpayers' subsidising the banks' shareholders, he confronted a moral hazard that eventually made it impossible for the congress to pass the reform, even though the negotiations consumed the entire year and valuable political capital. This

6 Today no single party holds a majority in the house or the senate, although the PAN and PRI together hold 83 percent of the two houses.

first failed attempt at reform also exposed extremely poor coordination within the cabinet and major mistakes in the relationship of the executive with the congress. The outcome suggests that Fox must have more intense planning, provide greater leadership, and eventually overhaul his cabinet in order to avoid similar failures with future reforms.

The president has now proposed reforms in electricity and gas, which appear to be less problematic for the congress. A reform of oil exploration and production would be much more difficult because three generations of Mexicans have viewed this sector as a symbol of nationalism. Although no one has yet detailed the proposed reforms to labour laws, unions have already vowed opposition.

Yet, although it is true that the failure of tax reform in 2001 created a negative precedent and appears to bode poorly for future reforms, it is not necessarily impossible to modernize the economy or to make further advances on integration with the rest of North America. The valuable lesson of 2001 is that market liberalization and deregulation in Mexico must meet much higher standards of transparency and public interest than were prevalent in the reforms of the 1990s. Such standards would be in line with those demanded in the United States and Canada, especially since the Enron watershed. If reform proposals in Mexico met such higher standards and negotiations begin in the congress, the prospects for modernization and integration with North America would be boosted automatically.

Market liberalization and deregulation in Mexico must meet much higher standards of transparency and public interest than were prevalent in the reforms of the 1990s.

At present, members of congress weigh Fox's reform agenda in the light of their perception of public opinion. Thus, although they have applauded his efforts to improve the conditions for labour migration to the United States, they have been unwilling to endorse the liberalization of electricity and gas or the reform of labour. Given this part of the political legacy of many years of nationalism, Fox and his government must find ways to create a new political consensus, which until now has been a priority second to negotiations with the United States on labour.

This ordering of priorities explains why, after a year and a half of a new government, Mexico shows no progress in areas that would attract more foreign investment and assure a higher rate of economic growth. Fox must now concentrate on a domestic agenda, and only when it begins to bear fruit can Mexico's proposals on economic integration with the rest of North America carry the weight they need to make them attractive to Canada and the United States. In the absence of concrete accomplishments in domestic reforms, Fox runs the risk that his bold initiatives will be ignored as impractical or premature by governments and international investors.[7]

I am not saying that structural reforms would be a panacea for Mexico. Its current problems result from a long period of foreign indebtedness and debt crisis, hyperinflation, loss of business confidence, and currency devaluations. In the mid-1980s, it started to reform its economy, reducing the size of the state, and by the mid-1990s, the NAFTA was leading to an unprecedented boom in exports. But at

7 Canadian officials' attitudes illustrate this risk. Mexico's idea of creating a fund for development along the lines of that of the EU is not well suited for North America. For one thing, Canada is already a member of two development banks. On the idea of developing a new North American agenda, the response is usually that Canada has successfully approached its bilateral issues with the United States and the benefits of a trilateral approach are not clear enough. Instead, and rightly, Canada sees great potential in the Free Trade Area of the Americas (FTAA). See "North American Linkages" 2000.

the same time, its social problems multiplied: social inequity increased dramatically, the quality of public services, including education, collapsed, and extreme poverty came to afflict 40 million of its 100 million inhabitants. No set of structural reforms can correct such imbalances in any foreseeable period of time. Reforms are essential, however, because Mexico has already opened up its economy to international trade; the only way to remain competitive and to create jobs is by becoming more efficient. Reforms are indispensable for overcoming lack of domestic capital and technology to modernize entire sectors of the economy.

Fox's Proposed Reforms

President Fox's original proposals on North American integration may seem reasonable if one takes a long-term view of the three economies involved and their potential to complement each other. But such ideas must first be tailored to the tradition of North American institutions, which, in fostering international cooperation, tend to consider market-based mechanisms rather than government-sponsored schemes. As Fox enunciated his proposals, they largely derive from academic studies drawing on the experience of Europe, which is not likely to apply in the North American system of free enterprise, low government intervention, and pragmatism (Wilson-Forsberg 2002; Pastor 2001).

North Americans are more likely to accept initiatives of an economic nature than initiatives involving political agreements.

As president-elect, Fox visited Canada and the United States in August 2000 and described his vision of North America. He urged that the three countries consider a currency union, a labour agreement, and a regional fund to finance development in Mexico, the least-developed area in the region. All three partners would benefit in the long run from improved education and infrastructure in Mexico. But the lack of enthusiastic response made Fox withdraw some of his proposals and focus instead on a labour agreement with the United States. By early 2001, he had already shifted from an all-encompassing agenda to an incremental approach.

The events of September 11, 2001, have compelled Fox to be even more selective in his aims, which he can do by focusing on those ideas likely to capture the interest of the United States and Canada. Such themes must carry great economic significance for the three NAFTA countries. For one thing, trade with and investment in Mexico could benefit from further deregulation, better infrastructure to help business remain competitive, and fewer restrictions on specific economic activities. For another, new business opportunities must be found before additional investment moves into Mexico. The positive public perception today of the NAFTA suggests that all North Americans are more likely to accept initiatives of an economic nature than initiatives involving political agreements.

Financial Integration and Dollarization

In Mexico, the idea of a financially integrated North America has great appeal to the financial sector, which would benefit from the reduced cost of capital and from access to larger amounts for development than are now available. But Mexico has had much experience working with different financial regimes, experience that suggests that financial integration should happen of its own, not be forced by governments. For that reason, Mexican institutions today are not ready or willing

to contemplate dollarization. Knowing this, the administration has indicated that in 2003 it will seek only convergence of the Mexican rate of inflation with that of the United States. The authorities expect that financial markets will interpret this objective as a firm commitment to financial stability, which would eventually bring those markets to reduce the cost of lending to Mexican borrowers.

For economic reasons, dollarization is neither feasible nor necessary. One reason is that Mexico has had bad experiences in the past with fixed exchange rates and pegs to the US dollar; they resulted in massive devaluations and loss of confidence once trade deficits reached high, unsustainable levels. A second reason is that stability does not require a fixed exchange rate: Mexico was able to reduce inflation from 52.0 percent in 1995 to 4.4 percent in 2001 under a floating rate regime. Moreover, this regime afforded flexibility to accommodate external shocks from crises in Asia, Russia, and Brazil in recent years. A floating rate has become validated as the best possible regime for adjusting to external shocks, such as a US recession or a sharp fall in oil prices. The third reason is that surrendering monetary policy to the US Federal Reserve would take away from the Mexican authorities one of the major instruments of economic policy.

The US Fed might also find it awkward to be exposed to acting as Mexico's lender of last resort — an important risk of dollarization. In the event of a liquidity crisis in Mexican commercial banks that was severe enough to threaten instability in the broader US dollar currency area or that raised important foreign policy concerns, the Fed would face pressure to extend funds in circumstances where timely repayment would be uncertain. Recall that, in the past few years, the Mexican authorities have had to bail out domestic banks by injecting $100 billion of taxpayers' money (20 percent of GDP). This memory alone should be enough to discourage any foreign central banker from contemplating being even a *de facto* lender of last resort to Mexico.[8]

The floating exchange rate regime, in place since 1995, has been instrumental in facilitating growth in manufactured exports.

The Peso Exchange Rate

The floating exchange rate regime, in place since 1995, has been instrumental in facilitating growth in manufactured exports. Mexico needs to compensate for inflation that is higher than in its two North American partners; it also depends significantly on oil exports, which fluctuate heavily in response to changing prices. From early 1999 through April 2001, the peso sustained steady appreciation against the US dollar, notwithstanding that cumulative inflation in Mexico was 30 percent, much more than the nine percent rate in the United States. One reason was that foreign capital inflows and speculation increased, especially at the end of 2000, with the prospects of a new phase of structural reforms led by Fox and with international rating agencies' upgrading of the quality of Mexican public debt.

This rapid strengthening of the peso against the US dollar was a mixed blessing, as it hurt competitiveness and encouraged some companies to move operations to

8 Banks were privatized in 1991 as part of de-regulation and reform policies of th government. Nevertheless, the privatization was plagued with vice by new owners close to the authorities, engaging in massive related-party lending with unsound practices and extremely poor supervision. Escalating loan defaults in the 1995 crisis compelled the government to rescue them from bankruptcy.

other countries. Most of the tire industry, for example, closed in 2002, citing exceedingly high labour costs, and Mexico became a net importer of tires. Other industries — among them, electronics, car parts, textiles, and clothing — have also moved out. And Mexican steel producers are now beginning to consider the possibility of locating at least some production lines in China. In brief, the sharp appreciation of the peso was not sustainable over the medium term, given the negative effects it had on industry (Orozco 2001; Luhnow 2002).

Nevertheless, foreign investors' confidence has been boosted by government assurances of making convergence of Mexican and US inflation a top priority in 2003. Financial markets have rightly interpreted this pledge as requiring the full adaptation of Mexico's monetary and other macroeconomic policies to those of the United States, most likely eliminating the possibility of any significant currency depreciation. But pursuing a convergence objective in a time of recession has cost economic activity dearly. The Bank of Mexico had to keep interest rates high, leading the peso to appreciate while most of Mexico's competitors saw depreciation of their exchange rates (Benavides 2002). Investors in financial instruments took advantage of the bank's tightened monetary policy by buying short-term government securities and profiting from high interest while rates elsewhere in North America were falling. These investors thus obtained high returns on Mexican paper at practically no risk.

In reality, Fox's ideas were neither new nor original, and they failed to engage either the United States or Canada in constructive discussion.

Only in late April 2002 did the Bank of Mexico react to mounting domestic and international criticism of its strong policy by increasing liquidity and signalling that it wanted the peso to depreciate. The exchange rate has fallen from 9.1 to 9.7 to the US dollar, but the peso was still 22 percent overvalued in mid-2002.[9]

Post–September 11, 2001

The fallout from the events of September 11, 2001, has greatly affected the chances of President Fox's bold proposals on integration within the NAFTA coming to fruition. Before that day, some of his ideas appeared to be new and thought provoking. But their positive reception was mainly because they came from a new leader, elected by a democratic vote, which could not be said of most of Fox's PRI predecessors. In reality, these ideas were neither new nor original, and they failed to engage either the United States or Canada in constructive discussion.[10]

Given long-term demographic trends in North America, Fox's proposal to facilitate the migration of Mexican labour to the United States seems to have some possibility of reaching the negotiating table, if appropriately tailored to US interests. Fox had suggested that the United States grant some legal status to Mexican workers who had illegally entered that country — a difficult proposition in view of the sensitivity of conservative groups with influence in the US Congress. Since September 11, 2001, this difficulty has become almost insurmountable, given the United States' increased focus on physical security, especially on its southern

9 This overvaluation is calculated on the basis of purchasing power parity using Mexico's and US consumer price indices with 1997 as a base year.

10 Indeed, one commentator says, they were received in Canada with "polite scepticism" because its government "tends not to look 20 or 30 years down the road, preferring a more incremental and pragmatic approach to policy making" (Wilson-Forsberg 2001).

border. Of concern is not only the migration of Mexican workers northward, but also the lack of security at Mexico's southern border, which many other illegal workers cross from Central America.

Thus, a labour agreement with the United States now has very little chance of materializing. If such an agreement were to be negotiated, the Mexican government would probably be required to enhance security at its two borders and to reassure the United States that migration from Mexico would not be to the detriment of security. In practice, this assurance would be easier said than done, for Mexico has not been able to dent the flow northward of drugs across the US border, while its justice system and police forces continue to suffer from corruption. More important, enhanced security would require a considerably enlarged allocation of public resources, which the Mexican congress could approve only at the expense of badly needed social services.

September 11, 2001, also highlighted North America's high dependence on oil from the Middle East, which may become a long-term cause for concern. Mexican oil reserves and the prospect that greater exploration may reveal more suggest that closer cooperation is possible. But for that course to be feasible, Mexico would need to make huge investments in oil exploration and production, which would require access to technologies not available without large amounts of FDI. In general, the prerequisites for greater Mexican participation in North American energy supply — a thoughtful and detailed program for this sector, intense political negotiations with the congress, and implementation of domestic reform — are absent today.

Mexico, being so dependent on trade with the United States, continues to focus mainly on maintaining close communication with Washington.

September 11, 2001, reduced President Fox's chances of reaching an early agreement on labour with the US, but it brought about a sense or realism to him and his government with the strong message that he should give top priority to domestic economic reforms. Logically, it could also have opened up an opportunity for the three North American partners to begin new discussions on a trilateral union that includes not only trade and investment but also security and border issues. But this road is not the one the United States has clearly signalled it is taking. Having imposed trade restrictions on steel and agriculture, it is showing a strong preference for unilateral action, being much more preoccupied with its own security and domestic politics than with international cooperation.

In theory, at least, Canada and Mexico could discuss ways for increased trade and technical cooperation no matter what happens to trilateral negotiations on the NAFTA. But for that approach to be fruitful, the two countries would need to find out where they can move independently on a bilateral basis and how this cooperation could drive new trilateral agreements. For that, Mexico and Canada must determine which issues are of common interest. Energy is likely to be one of them.

Meanwhile Mexico, being so dependent on trade with the United States, continues to focus mainly on maintaining close communication with Washington; its request for widening the NAFTA is on hold. Thus, from the perspective of Mexico, entering discussion of further integration with Canada alone, without the participation of the United States, would call for a new definition of the enlightened interests of a bilateral relationship beyond the NAFTA. Potential trade and investment would influence such interests. What Canada represents to Mexico is measured not only by economic exchanges but also by its influence on North American affairs and in

the world. Trade and investment, however, have some of the most tangible effects on economic integration and would enlist an enthusiastic participation from both countries' firms.

A View to the Likely Future

The government Mexicans elected in 2000 will see its last year in 2006. That calendar should give it plenty of time to push an agenda of free market reforms. Of them, the most important would be in energy, given Mexico's need to boost its output of electricity and gas for its own needs and its special role in furthering North American integration. Other reforms are likely to include modernization of social security and health care, infrastructure, labour laws, and political relations between the congress and the executive so they can work efficiently with new democratic rules.

Such domestic reforms would fit well with increasing North American integration. This perception explains why international rating agencies, seeing the connection between greater integration and higher economic growth and stability, were willing to grant investment grade status to Mexican public debt (Garcia 2002). Nevertheless, the time this administration has left could prove too short a period for the government to make significant progress in all or even the most important of the reforms international investors expect. This potential problem is clear from the fact that the government has already consumed 18 months in pursuit of tax and electricity reforms without any success.

If President Fox is going to be successful in the coming years, he must build a broad political consensus in favour of the reforms he proposes.

If President Fox is going to be successful in the coming years, he must build a broad political consensus in favour of the reforms he proposes. Changes in energy policy to attract foreign investment would require changes in Mexico's constitution, which need a two-thirds vote in the congress.

To build this consensus, the government is likely to give attention to problems in sectors on which the NAFTA has had negative impacts — especially farming, where imports have led to much unemployment, hurting welfare and ultimately political stability in certain regions. During the past two years, farmers' protests against the effects of the NAFTA have grown continuously. The objectors include producers of corn and sugar; other groups showing increasing disaffection are cattle raisers and potato growers. Thus, the government is coming under pressure to respond with programs to help Mexican farmers.

The Mexican congress's support for constitutional change to liberalize energy policy may depend, at least to some extent, on the government's capacity to assist distressed economic sectors with greater credit, technical assistance, and investment in infrastructure. The success of such a strategy will depend on whether the economy returns to the five percent growth rates it experienced before the US slowdown, thereby increasing tax revenues, creating new jobs, and alleviating unemployment. These conditions are likely to materialize by the end of 2002, so the political climate to pursue energy reform through constitutional change may be more favourable by 2003.

A favourable political climate is much needed. During the first 18 months of his administration, Fox underestimated the independence of the congress, including the factions of his own party. Thus, the government made the error of issuing new regulations to encourage greater private participation in electricity projects without

changing the regulatory laws, let alone the constitution, on which such rules were based. At the request of all parties, including the PAN, the congress asked the supreme court to resolve the controversy about whether the executive was entitled to liberalize electricity to such a degree. In April 2002, the court ruled that Fox's regulations violated the constitution — a major setback, especially since the government had been calling on foreign investors, including Canadians, to participate in electricity projects in Mexico. This judgment set back the government by 18 months, and it will now have to start political negotiations from scratch, but probably too late to result in significant changes before the midterm congressional elections in July 2003.

These elections may give Fox's party the congressional majority he needs to pursue energy reform on firmer grounds. Also, time will probably favour such reforms, as the public becomes more and more impatient about the deficiencies of state producers of electricity, gas, and petroleum, and about blackouts, high tariff increases, costly gasoline at the pump, and environmental damage resulting from the lack of adequate emission controls.

Another important influence on the political climate for reform will be the relationship between Mexico and the United States. President Bush, early in his administration, raised expectations about greater cooperation between the two countries on migration. Now, however, the way in which the United States implements security measures on its southern border will be important for the political climate.

We are not likely to see the congress approve any important structural reform before the mid-2003 election.

Thus, we are likely to see in the coming year the Mexican government engaged in domestic political negotiations for energy reform. At the same time, it will probably try to keep negotiations on labour with the United States alive by addressing some of that country's concerns about security and by agreeing to greater coordination of the Mexican police and army with their US counterparts. The government will likely maintain close contacts with potential US and Canadian investors in energy. If it fails to obtain congressional support for changing the constitution, it may well rewrite secondary regulations to permit investors limited forms of participation.[11] (Although some firms may find such regulations attractive, I doubt they would grant sufficient legal security for large firms to justify sizable investments here.)

All indications are now that we are not likely to see the congress approve any important structural reform before the mid-2003 election. This election will offer an opportunity for Fox and the PAN to win a congressional majority, which would allow for constitutional changes and reforms in electricity and gas exploration and production by 2004. In an environment of high economic growth, labour reform may be possible by 2005, permitting, for the first time, part-time employment and hourly wages, while reducing excessive protection of workers.

But if the government leaves labour reform too late, the proximity of the 2006 presidential election would inhibit this and other reforms. Reforming the health care and pension systems and modernizing Petróleos Mexicanos (Pemex, the national oil company) to allow foreign investment in oil would have to wait until 2007–08. Fox could advance the reform process only by a small degree, so integration

11 Pemex has followed a similar approach to attract private participation in natural gas exploration through multiple service contracts, which disguise economic incentives for explorers as fees, avoiding a constitutional prohibition against risk contracts.

with North America on the basis of energy or new business opportunities would be very gradual.

The Future of Integration

In the deepening of the NAFTA, the Fox government sees a vehicle for speeding economic integration and solving many development problems by increasing trade and investment and by achieving closer cooperation for regional development policies involving freely mobile labour, a regional market for energy, and a development fund. On the basis of repeated messages from the Fox government that this agenda is feasible and under way, business expects new opportunities for investment.

Only in recent years has Mexico started to see the benefit of higher inflows of FDI, particularly from Canada (Deblock, Benessaieh, and L'Heureux 2002), in mining, auto parts, telecommunications, and banking — sectors where foreign investment had been restricted. In banking, for example, Mexico now permits foreign banks to control the largest institutions to a degree never contemplated during the NAFTA negotiations. In electricity, it has gradually allowed the private sector, including foreigners, to invest for generation and cogeneration. In gas, it has deregulated distribution, attracting FDI from the United States, Canada, and Europe.

What is needed in energy is structural reform — and changes in the constitution — to permit private participation in oil, gas, and electricity.

The events of September 11, 2001, are forcing Mexico to do more to become a full player in North American economic integration. It must pursue a domestic agenda for deregulation and structural reforms. It must also improve the legal system and guarantee nondiscriminatory treatment of foreign minority investors with a rigorous application of the recently enacted law of the securities market. These steps are already under way, although with mixed results.

Energy

Energy deserves a separate section here, given its importance to North American integration as well as its legal complexity in Mexico. Article 27 of the Mexican constitution dictates that all hydrocarbons remain the property of the nation and that no private investors be given franchises or concessions (Shields 2002) or engage through risk contracts in exploration.[12] For electricity, the mandate is that generation is the exclusive domain of the state and its distribution is reserved to the state entity, the Comisión Federal de Electricidad (CFE).

Changes to the secondary laws, enacted when the PRI had a majority in the congress, have made private sector generation possible, but even now it is limited to electricity for the generator's own use; any excess production must be sold to CFE. Because of these changes, many firms, including foreign ones, have invested in their own plants, reducing some costs and assuring a reliable source of power, but Mexico is far from creating a market for electricity.

Analysts now foresee supply bottlenecks in energy, so prospects for growth have become more uncertain. Crude oil reserves have fallen for the past ten years.

12 The participation of private investors has been limited to service contracts without any risk sharing.

Imports of gasoline and refined products are signalling warnings about the lack of investment and strategic planning in Pemex. Natural gas imports have jumped from ten percent of domestic demand to 13 percent in only five years and could reach 26 percent in 2009. The projected needs for investment in energy are $131 billion through 2009, but the state will be able to finance only 54 percent of that amount, according to the Mexican energy ministry (Padilla 2001).

What is needed in energy is structural reform — and changes in the constitution — to permit private participation in oil, gas, and electricity. Such reform would open the door to greater integration of energy markets with Canada and the United States, as investors from those countries seek to take advantage of investments they have already made at home. The rationale for North American energy integration also lies in geography: the prospect of finding large Mexican gas reserves south of the Texas and Oklahoma fields as an extension of the same geological formation and the possibility of exporting electricity to California.

Canadian and US investors have private capital and technology in energy and are willing to participate in new business opportunities in Mexico. The entire development of the energy sector is, therefore, a logical way for Mexico to deepen economic integration with North America and could open the road to comprehensive and significant changes in energy balances in North America a few years from now.

Under state control, electricity generation has suffered from disorderly subsidies and inefficiencies, making it impossible to have enough revenue for financing expansion.

If the reforms were effected, with more FDI in energy, infrastructure would become easier to finance with private capital. Setting investment rules in infrastructure that are attractive to the private sector would also be easier after the energy markets had been deregulated. Thus, in the absence of a North American fund for infrastructure development, such as Fox has proposed, energy deregulation would be a straightforward route for Mexico to follow in its quest for faster economic growth and North American integration.

In the short run, however, as mentioned above, the administration's entire agenda on energy depends on cooperation from the congress, and such cooperation is subject to political vagaries related to the mid-term elections of 2003. For that reason, I do not expect much progress with reforms until 2004 at best.

Outlook and Agenda

Over the next five years, Mexico will try to engage the United States and Canada in energy integration, but doing so will be feasible only if the congress approves structural reforms in this area. The agenda would begin with electricity and with gas exploration and production. Once these reforms materialized, deregulation of petroleum refining would be the next logical step, leaving oil exploration and production as the single field in which foreign investment did not participate.

This year, the government has been working on deregulating electricity (see Guerrero 2002), which has been fully under state control. Exports of electricity to the United States are likely if production in northern Mexico expands with new private investment, but that achievement depends on the regulations to be issued and on potential restrictions on distribution and pricing. Therefore, a successful outcome requires comprehensive and clear changes in the law. Moreover, because the availability of gas is key to investment in electricity, the success of electricity

reforms depends in large measure on the success of gas deregulation. Both sectors must be reformed simultaneously.

Under state control, electricity generation has suffered from disorderly subsidies and inefficiencies, making it impossible to have enough revenue for financing expansion. The government is compelled to make fiscal transfers to the sector of electricity distribution, using scarce tax revenues that ought to be put toward social services.

Gas exploration has been ignored for a long time while Pemex has suffered from insufficient funds for investing in crude oil exploration, refining, and chemicals.[13] The momentum of domestic demand is based largely on industry's need to shift from fuel oil to gas. Greatly increased imports of gas would make Mexico vulnerable to fluctuations in North American markets and prices, while lack of sufficient domestic supply would discourage investment in electricity and chemicals.

Currently, Mexican gas production is mainly associated with oil extraction, which is concentrated in the southern part of the country. Thus, no major gas supplies are available in northern regions, where industry is concentrated and where the demand for electricity will grow at high rates in future years. The opening of gas production to private investment is likely to occur first in the northern Burgos region, which is presumed to have large reserves.

Mexico must refocus its attention on attracting private investment by continuing with deregulation.

In Burgos, Pemex will try to attract FDI to gas exploration through multiple service contracts (Muñoz 2001). This solution to constitutional restrictions is, however, only a second-best way of attracting high inflows of FDI and technology because investors always know that the spirit of the constitution forbids risk contracts. The exploration of reserves in regions other than Burgos represents a higher risk and will have to start from scratch; it thus must await constitutional reform.

Business Opportunities

The rationale for adopting a North American framework for greater economic integration in infrastructure development, as the Mexican government would like, is the need to assure good environmental conditions and efficient public services for industrial sites where Canadian and US firms may find it advantageous to manufacture certain products. Such firms often consider relocating to those sites because of Mexico's large but young labour force, its proximity to major cities and seaports of the southern United States, and its high-growth-potential market.

The strategy Mexico is likely to follow in infrastructure development is to allow private investment in certain services, such as toll roads and seaport facilities. The idea of receiving Canadian and US public funds to develop basic infrastructure seems unrealistic. Neither Canada nor the United States favours a new public fund. Both insist that Mexico use the facilities of the World Bank and the Inter-American

13 Business has not been able to fill the gap because, as already noted, the constitution bans private investment in this sector. The result of this neglect is that imports of gas had risen steadily to 10 percent of consumption five years ago and now stand at 13 percent. Meanwhile, domestic demand jumped 8.0 percent annually, while production rose only 1.1 percent (Pemex 2002). Presently, the trend is for domestic demand to rise at 8.8 percent and production at 6.5 percent, assuming a sharp increase in exploration and output (Guerrero 2002).

Development Bank. In addition, the North American Development Bank finances projects in Mexico's northern region. Therefore, Mexico must refocus its attention on attracting private investment by continuing with deregulation.

The implication is that the Fox government will attempt to eliminate subsidies for public services, induce a change in collective labour agreements by negotiating with unions, and guarantee investors a solid legal system. But these changes will probably take a good two or three years, which means that private equity in Mexico's infrastructure will not be a reality before 2004 or later.

A variety of possibilities exists, even outside the usual public services. Mexico privatized its two major airlines in the early 1990s but later had to rescue them from bankruptcy, take back ownership, and merge them into a single consortium. Now, the government has little capacity to steer these airlines into modernization and efficient operation in a competitive global market. Thus, it will probably want to sell them again to the private sector. However, since the airlines need capital as well as consolidation and development of domestic and international routes, Mexican investors alone are unlikely to be able to purchase and operate them efficiently. Canadian and US airlines are natural candidates to buy a stake in Mexican airlines, but they are unlikely to do so unless there is a substantial improvement in the global airline industry's financial conditions.

President Fox's proposals are likely to lead to only gradual and incremental progress on Mexico's path toward North American integration.

The Fox government has entertained the idea of a private health system that would coexist with the state system and, like it, be funded by premiums paid by workers and employers.[14] To the extent that some privatization becomes feasible in this sector, US and Canadian institutions would be natural providers of insurance; they would also be attracted by the opportunity to enter such a large new market.

Most of the financial services sector, including banks, brokerage firms, and fund management firms, has already been opened to foreign investors. Even so, there is potential for greater foreign participation in new financial services — the penetration of banks in the economy, measured as the balance of bank financing as a percentage of GDP, is only 19.7 percent in Mexico compared with, for example, 64.4 percent in Chile (Authers 2002).

When the peso collapsed in 1995, bank financing in Mexico fell dramatically as banks unloaded their bad loans on the government's rescue agency and recapitalized themselves with large issues of government debt. Later, they sought and found foreign partners, which have since assumed control (Willoughby and Conger 1998). Among banking products with good market potential are the management of retirement pension funds, which have grown in only five years to $22 billion (3.6 percent of GDP), and housing loans.

Also, the congress now allows pension funds to put part of their assets in foreign-investment-grade instruments. In placing debt with Mexican pension funds, Canadian and US issuers will probably have an advantage, given that these companies are better known in Mexico than their international counterparts. The presence of a major Canadian bank in Mexico should be an advantage for establishing greater links between Canadian issuers and Mexican pension funds.

11 The idea of a private system is attractive to many individuals and corporations because of the poor quality of state services.

Conclusion

President Fox's proposals are likely to lead to only gradual and incremental progress on Mexico's path toward North American integration, as such initiatives depend on structural and legal reforms that will take time — perhaps until 2009, the midpoint of the next presidential administration. The country has, however, already taken an important step toward integration as a result of its successful adaptation to the NAFTA. Since that agreement was implemented, Mexico's economy has grown by 5.5 percent annually and employment in manufacturing by 2.5 percent, rates not seen since 1980. Furthermore, the quality of this growth has been superior to similar but shorter cycles in the past in that it has been based on the solid expansion of manufactured exports and has not caused large trade deficits. The macroeconomic crises Mexico experienced in the 20 years before 1994 are no longer likely, provided it maintains its focus on strengthening manufacturing by remaining competitive, attracting FDI, and seeking further integration with its northern trading partners.

Accelerating that integration calls for continuing deregulation in banking, financial services, and telecommunications and expanding it into other areas in need of reform. The most ambitious of such new reforms would be in energy and labour. Energy is a natural vehicle for deepening North American integration. Mexico began deregulating the electricity sector in the mid-1990s, but the process of engaging the private sector fully in its development is incomplete. If successful, electricity reform would attract massive private investment in power generation and trigger large exports to the United States, particularly California.

Given the fallout from September 11, Fox's North American agenda is feasible only inasmuch as it is an economic agenda, not a grandiose political agenda.

The existence of rich gas reserves in northern Mexico and projections of strong growth in demand from new electricity generators mean that opening the gas industry to private and foreign investors is essential to the success of Mexico's electricity policies. It would also significantly improve the overall business climate.

Other areas with the potential to help deepen North American integration are infrastructure development, the privatization of airlines, and further development of financial services. The Fox government will probably try to demonstrate to foreign investors progress in all these areas because it knows that increased investment is key to deepening the NAFTA and raising growth prospects for years to come. Fox is likely to succeed in eventually delivering some important aspects of electricity and gas deregulation, but progress may be slow, given opposition from the congress and the political inexperience of his cabinet.

The most important thing to bear in mind is that, given the fallout from September 11, 2001, Fox's North American agenda is feasible only inasmuch as it is an economic agenda, not a grandiose political agenda. Delivering that larger economic agenda successfully depends first on achieving domestic economic reforms. Doing so would assure a positive response by the private sector, raise business confidence in Mexico, and eventually gain the recognition and interest of the governments of the United States and Canada.

For their part, Canadians need to remember that any integrative initiative they seek to develop with Washington must be open to including Mexico. Such openness is at heart a matter of sensitivity to the realities of the US body politic, but it may also be economically advantageous. So may joining with Mexico in attempting to gain more secure access to US markets.

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